BEFORE

THE PUBLIC SERVICE COMMISSION OF

SOUTH CAROLINA

DOCKET NO. 89-229-C - ORDER NO. 91-362

MAY 28, 1991

IN RE: Application of United Telephone Company of the Carolinas to Increase Certain Rates and Charges for Intra-State Telephone Service in South Carolina.	)	ORDER APPROVING RATES AND CHARGES

I.

INTRODUCTION

This matter is before the Public Service Commission of South Carolina (the Commission) on the application of United Telephone Company of the Carolinas (United or the Company) for authority to change and/or increase certain rates and charges for intrastate telephone service provided to the public by the Company in the State of South Carolina. The Company's November 29, 1990, application was filed pursuant to S.C. Code Ann. § 58-9-520 (Supp. 1990) and 26 S.C. Code Ann. Regs. 103-830, et. seq. (1976).

According to the Company's application, its proposed rates and charges would have produced additional gross revenues of $1,663,877 had they been in effect for the twelve month period ending September 30, 1990. The Commission Staff (Staff) calculated that the requested rates and charges would produce $1,664,357 in additional revenues. The Company's presently authorized rates and charges were approved by Order No. 88-604, dated July 1, 1988, in Docket No. 86-625-C.

By letter dated December 4, 1990, the Commission's Executive Director instructed the Company to publish a prepared Notice of Filing and Hearing, once a week for two consecutive weeks, in newspapers of general circulation in the Company's affected service areas in South Carolina. The Notice of Filing indicated the nature of the Company's application and advised all interested parties of the manner and time in which to file appropriate pleadings. The Company was likewise required to directly notify all customers affected by the proposed rates and charges. On February 19, 1990, the Company furnished affidavits demonstrating that the Notice of Filing and Hearing had been duly published in accordance with the instructions of the Executive Director. In addition, the Company certified that a copy of the Notice of Filing and Hearing had been mailed to each customer affected by the rates and charges proposed in the Company's application. Petitions to Intervene were filed on behalf of Steven W. Hamm, the Consumer Advocate for the State of South Carolina (the Consumer Advocate), by AT&T Communications of the Southern States (AT&T), and by Jonathan E. Gillespie.

On December 27, 1990, the Commission directed the Company to file and serve on all parties of record copies of the testimony and exhibits of its intended witnesses by January 11, 1991. The Company timely filed the prepared direct testimony and exhibits of the following four witnesses: Thomas W. Sokol, Vice-President - Administration; John D. Quackenbush, Manager - Rate of Return; Rex

W. Baker, General Accounting Manager; and Charles S. Parrott, Director - Rate Planning and Rate Case Matters.

On February 8, 1991, the Commission directed the Staff and all other parties of record to file with the Commission and serve on all parties of record the testimony and exhibits of their intended witnesses by February 25, 1991. The Consumer Advocate timely filed the direct testimony and exhibits of Michael J. Ileo, President and Senior Economist of Technical Associates, Incorporated; John B. Legler, Professor of Banking and Finance, College of Business Administration at the University of Georgia; and David J. Effron, a Certified Public Accountant. AT&T timely filed the direct testimony of Ronnie S. Dowdy, Manager - State Government Affairs for AT&T. Mr. Gillespie did not file any direct testimony. The Staff timely filed the direct testimony and exhibits of Steve W. Gunter, Public Utilities Accountant; James M. McDaniel, Chief, Telecommunications Department; David S. Lacoste, Engineer, Telecommunications Department; and James E. Spearman, Assistant Public Utilities Economist.

Thereafter, in accordance with the applicable provisions of law and the Commission's Rules of Practice and Procedure, a public hearing relative to the matters asserted in the Company's application was commenced on March 5, 1991. The Honorable Marjorie Amos-Frazier presided. William F. Austin, Esquire, and James B. Wright, Esquire, represented the Company. Elliott F. Elam, Jr., Esquire, Nancy J. Vaughn, Esquire, and Raymond E.. Lark, Esquire, represented the Consumer Advocate. Francis P. Mood, Esquire, and

J.R. Ortiz, Esquire, represented AT&T. Gayle B. Nichols, Staff Counsel, represented the Commission Staff. Mr. Gillespie was not present at the hearing. The record consists of three volumes of transcribed testimony and 15 hearing exhibits. Briefs were filed on behalf of the Company, the Consumer Advocate, and AT&T.

Upon full consideration of the Company's verified application, the evidence presented at the hearing, and the applicable law, the Commission makes the following findings of fact and conclusions of law.

II.

FINDINGS OF FACT

1. The Company is a South Carolina corporation authorized to conduct a public utility business in the State of South Carolina. The Company is a wholly-owned subsidiary of United Telecommunications, Inc. Application.

2. The Company owns and operates exchanges and lines providing local exchange telephone service to approximately 69,000 access lines located in Beaufort, Branchville, Chappells, Cross Hill, Estill, Eutaville, Greenwood, Hampton, Hodges, Holly Hill, Laurel Bay, Mountville, Ninety-Six, Ridgeland, Saluda, St. Helena, Troy, and Ware Shoals, South Carolina. Application. These exchanges are divided into two operating districts which are maintained in the Beaufort and Greenwood areas. Hearing Exhibit 13.

3. The Company's present rates and charges were approved by Order No. 88-604, dated July 1, 1988, in Docket No. 86-625-C.

Application.

4. The Company proposes to change its rates and charges for its intrastate Special Access Service. These proposed changes will increase the Company's annual revenues by $29,208. Company asserts that the proposed increase to the Special Access Service mirrors the Company's Federal Communication Commission's (FCC's) approved interstate rate for similar interstate service. The Company suggested that the proposed charge will prevent tariff shopping by interexchange carriers and resellers and will ease billing and administration. Parrott testimony. This increase is +1.76% of the Company's total requested increase in revenues.[1]

While AT&T supports Company's proposal to mirror interstate Special Access rates in its intrastate Special Access tariff, AT&T is concerned that the proposed Special Access rate will create a greater disparity between interLATA Special Access rates and intraLATA private line rates. AT&T contends that because intraLATA private line service and interLATA Special Access services are functionally equivalent, both services should be offered from a uniform tariff or from a single tariff. AT&T states that presently, Company's rates for intraLATA private line services are

1. In Hearing Exhibit 13, the Staff calculated the percentage of the total requested increase represented by each of the increases/decreases in charges for each of the Company's affected services. Since the Company altered its proposed rate design after Staff filed its exhibits, Hearing Exhibit 13's percentages are no longer correct. The Staff has made adjustments to properly reflect the changes in the Company's rate design. The percentages cited in this Order have been updated since the hearing.

well below that charged for Special Access services. While admitting that the disparity between interLATA Special Access and intraLATA private line rates is not unique, AT&T recommends that the Commission approve Company's Special Access tariff as filed and order Company to file at a future date an intraLATA private line tariff which reflects the same rates and structures as its intrastate Special Access tariff. Dowdy testimony.

5. Through the restructuring of its Switched Access Service, the Company proposes to decrease its revenue by $22.00. The Company proposes to restructure its Switched Access Service in three ways: (1) aggregate the end office switching, line termination, and intercept rate elements into one billable local switching rate element; (2) establish a single rate for all local switch services provided in equal access offices; and (3) provide a 55% discount for non-premium local switch services in non-equal access offices. According to the Company, this restructuring is consistent with the FCC's findings in FCC Docket 87-113 for interstate services. Company witness Parrott states that these changes would result in an annual revenue decrease of $22.00 and will have a neutral effect on ratepayers. Parrott Testimony.

AT&T states that increasing the discount rate for non-premium switched services in non-equal access offices from the present 35% to 55% has no basis in cost and will result in decreased revenues to the Company. AT&T recommends that the Company continue with the 35% discount but eliminate the discount as end offices are converted to allow for equal access. Dowdy testimony.

6. The Company proposes to eliminate its Improved Mobile Telephone Service (IMTS) on May 30, 1991, due to the introduction of cellular telephone service. Witness Parrott testified that IMTS has become "vintage technology" with the advent of cellular mobile technology. He testified that it is costly to repair existing IMTS equipment. Parrott also testified that the Company has received an order from a cellular mobile carrier for interconnection to the public switched network effective February 1, 1991, in Rural Service Area 2. Rural Service Area 2 encompasses that portion of the Company's service area where it offers its IMTS. The elimination of this service will reduce the Company's revenues by $29,617. Parrott's Testimony. The elimination of this service is not an unusual request within the South Carolina telecommunications industry. Hearing Exhibit 13. The elimination of this service reduces revenues by 1.78%.

7. The Company proposes to increase its monthly rates for some directory listing services. The Company proposes to increase additional listing charges by 10¢ per month for each additional line requested. The Company proposes to increase the proposed charges for non-published and non-listed telephone number service by 30¢ per month. The Company contends that its proposed rates recognize the value-added characteristics of the optional listings and that the additional annual revenue will help lower the rate for basic overall ratepayers. Parrott testimony. The proposals will generate additional revenues of $47,069 which are +2.83% of the total additional annual revenue requested.

8. The Company proposes to increase its charges for several Central Office Features to which local exchange customers may subscribe on an optional basis. The Company proposes to increase its Call Waiting and Three-Way Calling rates for business and residential customers by 25¢ per month. The Company is proposing monthly increases ranging from 25¢ to $1.00 for the various Toll Restriction Services it offers. The Company proposes to increase its Direct Inward Dialing number charges by 15¢ per month and to increase its optional Rotary Trunk Hunting service by $3.00 per month. The Company also proposes to raise the residential rate for Touch Tone service from 45¢ to 50¢ per month. The Company asserts that its Central Office Features allow it to increase its investment in state-of-the-art call-handling facilities by offering value-added services at a minimally increased cost. Parrott testimony. The increase as proposed by the Company for these services will generate additional revenues of $219,309. This proposed revenue increase constitutes +13.18% of the total requested revenue. Staff proposed to eliminate charges for Touch Tone service.

9. The Company has proposed several changes to its Advanced Business Connections (ABC) service. The Company's ABC product is its name for Centrex service. Parrott testimony. ABC functions similarly to a customer premises based Private Branch Exchange System (PBX). McDaniel Testimony. The Company proposes to increase the monthly rate for the originating Network Access Register (NAR) to $50.00 and to eliminate the charges for the

terminating NAR. Additionally, the Company has proposed bundling the Touch Tone rate into the station line rates associated with its ABC service. Further, the Company proposes to establish an intrastate ABC line credit of $6.00 and a NAR surcharge of $6.00. Parrott testimony. The revenue impact of these proposed changes increase revenues by $13,322. This increase is +.80% of the proposed total revenue increase.

AT&T contends that the Company's Touch Tone service should not be bundled into the rate elements of its ABC service. AT&T argues that the charges for Touch Tone service should reflect the cost incurred to provide the service and should not be subsidized by other services. Dowdy Testimony.

AT&T also objects to the Company's proposal to establish a $6.00 intrastate line credit for its ABC customers. AT&T contends that the Company's proposed credit is designed to offset the Federal Subscriber Line Charge. AT&T states that it is unclear from the Company's filing whether the proposed credit is being funded from sources of intrastate revenue other than from the ABC service offerings. AT&T suggests that the net result of the proposed filing is that non-ABC multiline business customers are charged $6.00, residential customers are charged $3.50, and multiline ABC-customers are charged only 60¢. AT&T recommends that the Commission require the Company to reflect the Subscriber Line Charge as a separate unbundled rate element for ABC customers. AT&T Witness Dowdy admits that the Company's ABC service and a PBX system are competitive services and that the Company's charge for its ABC service is less than a PBX subscriber line charge. Dowdy Testimony.

10. The Company proposes to consolidate its service areas into two zones: one within the base rate area and one outside of the base rate area. The Company proposes to charge a rate of $2.00 to individual-line customers and $1.75 to multi-party customers outside the base rate area. These proposed changes would yield additional annual revenues of $24,579. Parrott Testimony. This increase is +1.48% of the Company's requested increase.

11. The Company proposes to increase its local exchange service rates by an average of 10%. The change in these rates will increase the Company's revenue by $1,359,437. Except for changes in multi-party rates, the increased local exchange rates maintains the differential between basic local residential and business rates approved by the Commission in the Company's previous rate case. The Company proposes to move Two-Party and Four-Party rates closer to individual line charges. Parrott Testimony. Staff calculates that the increased revenues from Local Exchange Rates constitutes +81.73% of the Company's requested increase.

12. The Company states that despite its attempts to improve earnings through increased productivity, it has been unable to earn the 13.20% return on equity approved by the Commission in 1988. The Company states that the need for continued investment to upgrade and modernize its telecommunications network has resulted in its inability to achieve its approved rate of return. The Company states that over the last four years, it has invested $48

million to provide new facilities and improve service. The Company states that its projects have brought digital switching capabilities to South Carolina. Finally, the Company explains that it is also in need of rate relief because it will be installing a digital central office switch in the Estill Exchange during the first quarter of 1991. Sokol Testimony.

13. The Company proposes that the appropriate test year upon which to consider its requested increase is the twelve month period ending September 30, 1990. Baker Testimony.

14. Under its presently approved rates, the Company states that its intrastate operating revenues for the test year, after accounting and pro forma adjustments, are $28,245,531. The Company seeks an increase in its rates and charges for telecommunications service in a manner which would increase its operating revenues by $1,660,716.[2] Baker Testimony; Hearing Exhibit 3. Under the Company's presently approved rates, the Staff found that the Company's per book intrastate operating revenues for the test year were $28,398,286 and that after accounting and pro forma adjustments, the operating revenues were $28,798,050. The Staff proposed a $399,764 adjustment to operating revenues.

Staff's adjustments to operating revenues are explained below:

2. The Company's proposed increase assumes a return on equity of 13.63%. Hearing Exhibit 3. With its adjustments, Staff calculated that the proposed increase of $1,663,877, as stated in the Company's application, would increase to $1,664,357. Hearing Exhibit 12.

Operating Revenues

(A) DirectoriesAmerica

Staff proposed to increase the Company's revenues by including all of the $556,653 income received by DirectoriesAmerica during the test year in United's revenues. DirectoriesAmerica is the Company's affiliate responsible for directory operations. Staff based this proposal on Order No. 85-1 (1985), Docket No. 84-308-C, where the Commission imputed the revenues and expenses of Southern Bell's directory affiliate to Southern Bell for ratemaking purposes. Gunter Testimony; Hearing Exhibit 12. Staff's proposal to increase revenues has a corresponding $207,632 increase to the Company's operating taxes.

The Company has not made an adjustment to its operating revenues for revenue received by DirectoriesAmerica. The Company contends that its per book revenue figure includes 60% of the revenues from DirectoriesAmerica. The Company contends that imputation of all of the revenues of its affiliate DirectoriesAmerica does not maintain the same impact on its ratepayers as existed prior to the 1986 creation of DirectoriesAmerica and that the 1985 Southern Bell decision is inapplicable. Company Witness Sokol testified that prior to the creation of its affiliate DirectoriesAmerica, the Company's directory operations were performed by L.M. Berry Company (Berry), an independent publishing company. (TR., Vol. 3, p.124, line 21-p.125, line 14). Under the Company's agreement with Berry, the Company received 60% of the revenues from directory operations (and paid certain related expenses) and 40% of the revenues remained with Berry. (TR., Vol. 3, p.39, line 1-p.40, line 5). The Company contends that, unlike the circumstances in Docket No. 84-308-C where Southern Bell published and received all revenue from its directories and then created a subsidiary to conduct its directory operations, the creation of DirectoriesAmerica does not have a revenue impact on its ratepayers because it continues to impute 60% of DirectoriesAmerica's revenues to its books as it did under its agreement with Berry. (TR., Vol. 3, p.127, line 12-p.129, line 23).

(B) Toll Pool Settlements

The Company proposed to increase its operating revenues by $39,821 to reflect the effect of its toll pool settlement with other local exchange carriers. The Staff made an adjustment of $35,700 for the same reasons. This difference is based on the Staff's corresponding adjustments to the Company's operating expenses.

14. The Company asserts that under its presently approved rates, its intrastate operating expenses for the test year, after accounting and _pro forma_ adjustments, were $23,517,912. Hearing Exhibit 3. The Staff concludes that the Company's operating expenses for the test year after accounting and _pro forma_ adjustments were $23,729,333. Hearing Exhibit 12. The Staff made this proposal after making the following adjustments to the Company's expense accounts.

Operating Expenses

(A) Lobbying and Advertising Expenses

Staff proposed to disallow all of the Company's costs associated with lobbying efforts. Accordingly, the Staff disallowed $21,321 of expenses. This disallowance had an effect on the Company's Plant Specific, Plant Non-Specific, Customer Operations, and Corporate Operations accounts. Likewise, the Staff's proposal had the effect of increasing the Company's operating taxes by $7,090. The Company did not make an adjustment for lobbying expenses.

Staff proposed to reduce the Company's advertising expense by $19,038. Staff proposed to disallow that portion of advertising expenses which were either promotional or institutional in nature. Staff's adjustment resulted in a $6,310 increase to the Company's operating taxes. The Company did not make an adjustment for advertising expenses.

(B) Legal Expenses

Staff proposed to amortize legal fees remaining on the books and associated with the Company's last rate case over a three year period. Additionally, the Staff proposed to amortize legal fees for other non-recurring legal matters over a five year period. These adjustments had the net effect of increasing the Company's expenses by $3,270 and decreasing the Company's operating taxes by $1,086. The Company did not make an adjustment for legal expenses.

(C) Employee Benefits

Staff proposed to disallow costs associated with an employee newsletter, membership dues, and employee gifts and awards. This disallowance reduced expenses by $46,962 and increased the Company's operating taxes by $15,571. The Company did not make an adjustment for these expenses.

(D) Moving Expenses

During the test year, the Company relocated some of its employees. Staff recognized that the relocation of employees as an unusual event. Accordingly, Staff proposed to recognize the average of the Company's moving expenses over the four (4) years prior to the test year. This proposal reduced the Company's expenses by $26,986 and increased its operating taxes by $8,849. The Company did not normalize its moving expenses.

(E) Payroll Expenses

1. Wage Increases. Both the Company and Staff proposed to annualize wage increases which took place during the test year. The Consumer Advocate contended that because the Company had ten less employees on its payroll as of December 31, 1990, than it did at the end of the test year, the Commission should make an adjustment of $169,000 in payroll expenses. The Consumer Advocate contended that while Company Witness Baker stated that the reduction in payroll expenses would be "largely replaced by costs that were billed by United Intermountain Telephone Company in Tennessee" (TR., Vol. 1, p. 126, lines 20-22), the witness did not provide any supporting documentation for this claim.

Alternatively, the Consumer Advocate argued that payroll expenses should be reduced by $20,000, which the Consumer Advocate claimed Witness Baker conceded was appropriate. (TR., Vol. 1, p. 127, line 3).

On cross-examination Company Witness Baker explained that the Company did not propose a <u>pro forma</u> adjustment to recognize the effect of ten (10) less employees on the Company's payroll. Baker testified that because employees of United Intermountain Telephone Company will perform the functions of the former ten (10) employees and the Company will be allocated a portion of their salaries, the Company did not adjust its payroll expenses. (TR. Vol. 1, p. 125, line 9-p. 127, line 3).

2. Annualization of Wage Increases. The Company and Staff proposed to annualize the effects of wage increases which took place after the test year. Staff, however, did not include increases which had not been finalized. Accordingly, the Company's adjustment increased expenses by $267,797 and reduced operating taxes by $89,063. Staff's adjustment increased expenses by $109,207 and reduced operating taxes by $36,285.

3. Officer Pay Increases. Staff proposed to eliminate officer pay increases that occurred during the test year. This adjustment reduced the Company's expenses by $8,619 and increased its operating taxes by $2,946.

(F) Annualization of Depreciation Expense

The Company and Staff proposed to annualize depreciation expense. The Staff based its adjustments on the test year ending balances while the Company based its adjustment on an adjusted end of period depreciation levels at the time its proposed new rates would go into effect. Staff's adjustment increased the Company's depreciation expense by $288,421 and reduced its operating taxes by $96,144. The Company's adjustment reduced its depreciation expense by $7,559 and increased its operating taxes by $2,513.

(G) Depreciation Expense - Estill Switch

Company proposed to record depreciation expense on the total estimated cost of a switch scheduled to be in service in the Estill service area in 1991. Because Staff proposed to disallow the Estill switch as an item of rate base, Staff likewise proposed to disallow all depreciation expense for the switch. (See, page 20). The Company's adjustment increased its depreciation expense by $42,835 and decreased its operating taxes by $14,381.

(H) Interest on Customer Deposits

Staff proposed to annualize interest on customer deposits using the Commission's 12% approved interest rate at the end of the test year. Staff's adjustment increased the Company's expenses by $6,560 and decreased its operating taxes by $2,447. The Company did not annualize interest on its customer deposits.

(I) Interest Synchronization

Both the Company and Staff proposed to record the effects of interest synchronization on income taxes. Because the Company and

Staff used different rate bases, the annualized interest expense, and ultimately the tax effect of annualized interest, are different.[3]

(J) Interest During Construction

Both the Company and Staff proposed an adjustment to reflect interest earned during construction at an end of period level. Staff, however, disallowed interest during construction on a short term project which the Company had reclassified as a long-term project after the test year. Accordingly, the Company reduced its expense of interest during construction by $5,059 more than Staff.

(K) Customer Growth

Both the Company and Staff proposed to record the effects of customer growth. While the Company and Staff used the same method to determine the customer growth factor, the Company and Staff used differing net operating incomes to arrive at the customer growth effect on expenses.[4]

(L) Depreciation Expense - Station Equipment Wiring

The Consumer Advocate argued that the remaining unrecovered balance in Account 2321, Station Equipment and Wiring, should be amortized over a three-year period. The Company proposed that the

3. Annualized interest expense is determined by multiplying the weighted average cost of debt by rate base. Thereafter, the tax effect of the difference between the per book interest expense and annualized interest expense is computed.

4. The Commission's approved customer growth formula is as follows:

$$\frac{\text{End of Year Customers} - \text{Average Customers}}{\text{Average Customers}} \times \text{Net Operating Income}$$

remaining balance be amortized within one year. Staff agreed with the Company's proposal.

15. Based on its pro forma and accounting adjustments, the Company concluded that its appropriate level of net operating income for return was $4,839,522. Staff concluded that based on its pro forma and accounting adjustments, the Company's appropriate level of net operating income for return was $5,186,429.

16. The Company contended that its original cost, South Carolina intrastate rate base, after accounting and pro forma adjustments, was $49,964,109. Staff concluded that the Company's year-end, original cost, South Carolina intrastate rate base was $48,887,590. The difference in these two rate base calculations is based on the following adjustments:

Rate Base

(A) DirectoriesAmerica

In keeping with its adjustment to operating revenues for revenues received by DirectoriesAmerica, Staff proposed to include plant and other rate base items of DirectoriesAmerica in the Company's rate base. Staff's adjustment increased the Company's rate base by $151,583 and decreased its accumulated depreciation by $56,417. The Company has not made a rate base adjustment for plant associated with DirectoriesAmerica.

(B) Estill Switch

The Company proposed to include in its rate base the amount of its investment reflected on its books at the time the new Estill switch is placed into service. At the hearing the Company estimated that the Estill switch would be in service in April 1991. As of the end of February 1991, the Company had spent $615,296 in capital expenditures on the switch. (TR., Vol. 1, p. 116, line 21-p.117, line 4).[5] On cross-examination, Company Witness Baker stated that the old Estill switch was fully depreciated and, therefore, retirement of the old switch was not required. (TR., Vol. 1, p. 119, lines 4-15). The Company asked that the Commission's precedent of limiting rate base to investments in use during the test year be waived or changed to permit inclusion of the switch in its rate base. (TR., Vol. 1, p. 30, line 21-p. 31, line 3).

Staff proposed to disallow inclusion of the Estill switch in rate base. Consumer Advocate Witness Effron stated that it was his opinion that the Estill switch should not be included in the Company's rate base. Witness Effron stated that the switch was not scheduled to be in service until April 1991, more than six months after the end of the test year. He explained that it would be inconsistent to recognize the costs associated with replacement of the switch without also recognizing the expense savings and additional revenues from the new switch. Finally, Witness Effron

5. The Company recorded $615,296 on its books for the Estill Switch. The Company recorded ($42,835) as the effect of the Estill Switch on its accumulated depreciation. Hearing Exhibit 3. By letter received by the Commission on May 20, 1991, the Company stated that its actual intrastate investment in the Estill Switch as of April 30, 1991, was $602,052.17. This late-filed Exhibit 4 was not received by the Commission until after it had made its decision on the proposed rate increase. Accordingly, the Commission did not consider this submission.

testified that according to its response to Consumer Advocate Interrogatory 3-9, upon completion of the Estill switch, the Company expected $1,240,000 in retirements from plant in service. Witness Effron noted that the Company had not proposed any adjustment to recognize these retirements. (TR., Vol. 2, p. 159, line 23-p. 160, line 15).

(C) Wage Adjustments

Staff proposed to adjust Plant in Service and Accumulated Depreciation to reflect the capitalized portion of the Company's wage adjustments. This adjustment increased rate base by $28,044 and decreased accumulated depreciation by $1,786. The Company did not make this adjustment.

(D) Accumulated Depreciation

Both Staff and the Company proposed to adjust accumulated depreciation to record the effect of annualizing the Company's depreciation expense. Since the Company and Staff's end of test year plant balances were different, the effect of annualizing depreciation differed.[6]

(E) Contributions in Aid of Construction

Staff recommended that the Commission deduct customer's contributions in aid of construction. This proposal reduced the Company's Plant in Service by $300,210. The Consumer Advocate supported this position. The Company did not make a similar

6. Annualized depreciation is determined by multiplying the end of year plant balance by currently approved depreciation rates. Thereafter, per book depreciation is increased by the difference between it and annualized depreciation.

adjustment.

(F) Materials and Supplies

The Company's intrastate per books materials and supplies at the end of the test year was $272,977. Neither the Company nor Staff made an adjustment to this book figure. The Consumer Advocate proposed that the average cost of the Company's materials and supplies during the test year be included in the Company's rate base. The Consumer Advocate contended that its proposed adjustment prevents a utility from distorting its materials and supplies at the end of the test year.

(G) Cash Working Capital

While the Company and Staff both used a 20-day cash working capital allowance, the Company computed its allowance based on operating and maintenance costs after pro forma and accounting adjustments. Staff computed its allowance based on the Company's per book operating and maintenance expenses.

(H) Annualization of Interest on Customer Deposits

Staff proposed to record the effect of annualizing interest on customer deposits. This adjustment decreased the Company's rate base by $6,560. The Company did not make an adjustment to annualize interest on customer's deposits.

(I) Unclaimed Funds

Staff recommended that the Commission reduce the Company's rate base by the amount of unclaimed funds it found on the Company's books during its audit. Staff's proposal reduced the Company's Cash Working Capital account by $2,289. The Company did not make an adjustment for unclaimed funds.

17. Each of the three cost of capital witnesses recommended that the consolidated capital structure of United Telephone System be used as the appropriate capital structure for the Company (TR., Vol. 1, p. 42, line 13-p. 43, line 4; Vol. 2, p. 110, lines 1-11; Vol. 3, p. 75, lines 3-6). Further, the cost-of-capital witnesses agreed that the embedded cost of long-term debt was 8.83% and that the embedded cost of preferred stock was 6.98% as of September 30, 1990, for the agreed-upon capital strucutre. (TR., Vol. p. 51, line 18-p. 19, line 3; Vol. 2, p. 111, line 12-p.113, line 12).[7]

18. In determining the Company's cost of equity capital, Company Witness Quackenbush testified he utilized the Discounted Cash Flow (DCF) approach and the Capital Asset Pricing Model (CAPM). Since the Company does not issue common stock, Quackenbush explained that he selected a group of seven market-traded companies as a proxy and used the Institutional Brokers Estimate System (IBES) projected earnings growth rates of the seven companies as a proxy for the dividend growth rate of the Company. Using a quarterly version of the DCF model, Quackenbush testified that he determined that the cost of equity capital for the individual companies in his proxy group ranged from 9.73% to 15.95%, with an average value of 13.40%. The average cost of equity capital for the proxy group, as determined by the CAPM, was 16.16%.

7. Staff Witness Spearman accepted Staff's Accounting Department's use of 8.83% as the embedded cost of long-term debt and 6.98% as the embedded cost of preferred stock.

Quackenbush testified he used the 9.35% average interest rate on U. S. Treasury bond futures contracts as the risk free rate of return and a 7.51% risk premium for the Standard & Poor's Composite Index over U. S. Treasury bonds as determined in the update to the Ibbotson and Sinquefield study entitled, Stocks, Bonds, Bills and Inflation: 1990 Yearbook. Quackenbush stated that the betas for the proxy companies, as determined by the Value Line Investment Survey, ranged from 0.80 to 1.00, with an average of 0.91. Thus, Quackenbush concluded that the cost of equity capital for the Company ranged from 13.40% to 16.16% before any adjustment for issuance costs. He testified that if one included the 23 basis points for issuance costs, the cost of equity capital would rise to a range of 13.63% to 16.39%, with a best point estimate of 15.01%. However, Quackenbush testified that the Company proposed the low end estimate of 13.63% as its cost of equity capital.

19. The Consumer Advocate's cost of capital witness, John Legler, testified he utilized the DCF approach and the risk premium approach to determine the appropriate cost of equity capital for the Company. He explained he also utilized three proxy groups, a group of ten independent telephone companies, the seven Bell regional holding companies, and the seven companies used by Quackenbush. Legler testified he also utilized two dividend growth rates in his DCF analysis, dividend growth rates as projected by Value Line and calculated retention growth rates based on Value Line projections of earnings per share, dividends per share, and return on common equity for each company in the proxy groups.

Using an annual version of the DCF model, Legler determined the cost of equity ranged from 10.40% to 13.01%. According to Legler, applying the risk premium approach to the independent telephone companies resulted in a cost of equity capital ranging from 11.77% to 12.97%. Legler's risk premium measured the difference between the expected return on equity for a proxy group and the yield on the thirty-year U. S. Treasury Bond. The risk premium ranged between 3.58% and 4.78%, depending on the time period (1978-1991 or 1987-1991) and on whether Value Line projected growth rates or calculated retention growth rates were used. The yield on the thirty-year Treasury Bond was 8.19% as of January 31, 1991. Legler concluded that the appropriate cost of equity capital for the Company ranged from 12.0% to 13.0%. He recommended that the rate be set at 12.5%. Witness Legler determined that no adjustment for stock issuance cost was necessary.

20. Staff Witness Spearman testified he also utilized the DCF and the CAPM approaches in determining the appropriate cost of equity capital for the Company. Spearman testified that he selected the seven Bell regional holding companies as a proxy group. Witness Spearman used the projected dividend growth rates from Merrill Lynch and Value Line for the Bell regional holding companies as a proxy for the dividend growth rates of the Company. Spearman testified that he utilized three versions of the DCF model: an annual model, a dividend reinvestment model, and a quarterly model with dividend reinvestment. The cost of equity capital for each company ranged from a low of 10.34% to a high of

13.67%, while the average for the group ranged from 10.88% to 12.14%. Adjusting for biases resulting from very high or very low cost of equity values for specific companies and for differences in business and financial risks between the Company and the proxy, Spearman testified that he narrowed his appropriate range, based on his DCF analysis, to 11.80% to 13.20%, with a best point estimate of 12.5%.

According to Spearman, his CAPM analysis resulted in somewhat higher estimates of the cost of equity capital of between 12.44% and 13.41%. Using a discounted value approach in conjunction with a historical market return analysis, Spearman determined the market return to be in the range of 13.50% to 14.50%. In consideration of differing stock holding time periods for investors, Spearman also testified that he utilized three risk-free rates of return, based on the 1990 average return on one-year, four-year, and twenty-five year U. S. government securities. The average beta for the proxy group was 0.81, with a range of 0.78 to 0.85. Spearman selected the Merrill Lynch betas which are based on the Standard & Poor's 500 Index rather than the Value Line betas which are based on the New York Stock Exchange Composite Index in an attempt to maintain consistency with his market return estimates which are also based on the Standard & Poor's 500 Index. Within this range of 12.44% to 13.41% for the cost of equity capital derived by the CAPM, Spearman selected a best point estimate of 13.00%.

Based on the results of both the DCF analysis and the CAPM analysis, witness Spearman concluded that the most appropriate cost of equity capital for the Company ranged from 12.50% to 13.00%, with a best point estimate of 12.75%. Witness Spearman concluded that no adjustment for stock issuance costs were necessary since the Company did not plan to issue stock.

III.

CONCLUSIONS OF LAW

1. The Company is a telephone utility providing telephone service in its service area within South Carolina. The Company's operations in South Carolina are subject to the jurisdiction of the Commission pursuant to S.C. Code Ann. §58-9-10(6)(1976).

2. A fundamental principle of the ratemaking process is the establishment of a historical test year as the basis for calculating a utility's rate base and, consequently, the validity of the utility's requested rate increase. Integral to the use of an average year representing normal operating conditions to be reasonably anticipated in the future, is the necessity to make normalizing adjustments to the historic test year figures. Only those adjustments which have reasonable and definite characteristics, and which tend to influence reflected operating experience, are made to give proper consideration to revenues, expenses and investment. Adjustments may be allowed for items occurring in the historic test year, but which will not recur in the future; or to give effect to items of an extraordinary nature by either normalizing or annualizing such items to reflect more accurately their annual impact; or to give effect to any other item which should have been included or excluded during the historic

test year. See, Parker v. South Carolina Public Service Commission, 280 S.C. 310, 313 S.E.2d 290 (1984), citing City of Pittsburgh v. Pennsylvania Public Utility Commission, 187 Pa.Super. 341, 144 A.2d 648 (1958); Southern Bell v. The Public Service Commission, 270 S.C. 590, 244 S.E.2d 278 (1978).

In light of the fact that the Company proposes that the twelve-month period ending September 30, 1990, is the appropriate test year and Staff has audited the Company's books for the September 1990 test year, the Commission concludes that the twelve-month period ending September 30, 1990, is the appropriate test year for the purposes of this rate request.

3. After considering the Company and the Staff's proposals as to the appropriate level of revenues which should be imputed from DirectoriesAmerica to the Company, the Commission concludes that, for the purposes of the present case, 60% of DirectoriesAmerica's revenues should be imputed to the Company's operating revenues. In Order No. 85-1, Docket No. 84-308-C (1985), this Commission addressed the effect of Southern Bell's decision to cease the publication of its own directories and to form a subsidiary to conduct its directory operations. The Commission stated that "to ensure that the establishment of BAPCO [the subsidiary] as a separate company causes no revenue requirement increase for Southern Bell's intrastate operations in South Carolina, it is necessary to make a pro forma adjustment, to test year directory revenues." Order No. 85-1, page 26. Based upon its determination that the establishment of the subsidiary's operations

should not adversely affect the Southern Bell ratepayers, the Commission required all of the subsidiary's revenues to be included as part of Southern Bell's operating revenues for ratemaking purposes.

In the present case, the Company's directory operations were performed by an independent publishing company. According to the agreement between the Company and the independent publishing company, 60% of the publishing company's revenues were to be allocated to the Company and the remaining 40% were to be compensation for the publishing company. In 1986, the Company established a subsidiary, DirectoriesAmerica, to conduct its directory operations. The Company continued to impute 60% of its subsidiary's revenues to its own operating revenues. The Commission concludes that since the Company's ratepayers received 60% of the revenues from the independent publishing company and continue to receive 60% of the revenues from DirectoriesAmerica, the ratepayers are in the same position for ratemaking purposes. Therefore, the Commission determines that the proper allocation of revenues from DirectoriesAmerica to the Company is 60%. The Commission puts all parties on notice, however, that in future ratemaking proceedings, 100% of the revenues of a subsidiary/ affiliate directory shall be imputed to the operating revenues of a jurisdictional telephone utility.[8]

The Commission also adopts Staff's proposal to include $35,700 in the Company's operating revenues for its toll pool settlement. The Commission recognizes that all long distance toll revenues collected for intraLATA calls are placed in a pool and that each local exchange company is allocated a portion of the revenue from the pool based on average cost of service. After considering the Company's proper expenses, the Commission concludes that the Staff's adjustment of $ 35,700 to the Company's operating revenues for toll pool income is correct.

4. Based upon its acceptance of the Company's proposal to include 60% of the revenues from DirectoriesAmerica and its acceptance of Staff's toll pool adjustments, the Commission concludes that the Company's appropriate operating revenues for the test year and after accounting and pro forma adjustments are $28,241,397.

5. The Commission concludes that Staff's adjustments to the Company's operating expenses are appropriate. The Commission makes this conclusion based upon the following legal principles and reasoning:

8. The Commission recognizes that, as a practical matter, yellow page advertising is marketed in conjunction with Commission-required white page directories. 26 S.C. Reg. 103-631 (1976). For this reason, the Commission will require in future proceedings 100% of the revenues of subsidiary/affiliates to be imputed in the telephone utility's revenues.

(A) Lobbying and Advertising Expenses

The Commission accepts Staff's proposal to disallow all of the Company's costs associated with lobbying. The Commission concludes that lobbying efforts benefit the investor, not the ratepayer, and, therefore, should not be included as an expense for ratemaking purposes.

Likewise, the Commission accepts Staff's proposal to disallow those portions of the Company's expenses related to promotional and institutional advertising. Advertising of this nature is not a necessary expense for the regulated activities of a utility and, therefore, should not be included as an expense for ratemaking purposes.

(B) Legal Expenses

The Commission accepts Staff's proposal to amortize its legal fees from its last rate case over a three-year period and to amortize the Company's other non-recurring legal fees over a five-year period. The Commission finds that these three and five year periods of amortization are reasonable in that they permit the ratepayer and shareholder to absorb the costs of legal expenses.

(C) Employee Benefits

The Commission adopts Staff's recommendation to disallow the Company's costs for an employee newsletter, membership dues, and employee gifts and awards. These employee benefits do not benefit the Company's ratepayers and are inappropriate for ratemaking purposes.

(D) Moving Expenses

The Commission accepts Staff's proposal to normalize the Company's moving expenses. The Commission concludes that the relocation of employees is an unusual event and, therefore, Staff's proposal to use an average of moving expenses is appropriate. Parker, supra.

(E) Payroll Expenses

1. Wage Increases. The Commission has considered the Consumer Advocate's proposal to disallow a portion of the Company's payroll expenses. While the number of the Company's employees may have declined from 212 during the test year to 202 by December 30, 1990, the Commission is persuaded that the Company will continue to have to absorb expenses for the performance of those employees' functions. Accordingly, the Commission declines to adjust the Company's payroll expenses to reflect the decrease in the number of employees.

2. The Commission accepts the Company's and Staff's proposals to annualize wage increases which took place during the test year. Likewise, the Commission accepts Staff's recommendation not to include wage increases which had been proposed but were not finalized during the test year.

3. The Commission accepts Staff's proposal to eliminate the Company's expense for officer pay increases. The Commission finds that officer pay increases should be absorbed by the investor and not be included as an expense for ratemaking purposes.

(F) Depreciation Expense - Estill Switch

The Commission accepts Staff's proposal to disallow depreciation expense on the Estill switch. This switch was not scheduled to be in operation until six months after the conclusion of the test year. Accordingly, the Commission concludes that depreciation associated with the switch should not be included in the Company's expenses for ratemaking purposes. (See, page 36).

(G) Annualization of Depreciation Expense

The Commission accepts Staff's proposal to annualize depreciation expense. The Commission rejects the Company's proposal to annualize its depreciation expense on its forecasted plant balances at the time the Company's new rates would take effect. The Commission concludes depreciation expense should be determined as of the end of the test year.

(H) Interest on Customer Deposits

The Commission accepts Staff's proposal to annualize the interest the Company owes on its ratepayers' deposits. The Company finds that the annualization of this expense is appropriate for ratemaking purposese.

(I) Interest Synchronization

As discussed below, the Commission accepts Staff's accounting and <u>pro</u> <u>forma</u> adjustments to the Company's rate base. Therefore, the Commission accepts Staff's adjustment for interest synchronization.

(J) Interest During Construction

The Commission accepts Staff's adjustment for interest during construction. Historically, this Commission has permitted interest expense for long-term debt existing during the test year to be considered for ratemaking purposes.

(K) Customer Growth

In light of the fact that the Commission has approved the Staff's net operating income, the Commission likewise approves Staff's adjustment for customer growth.

(L) Depreciation Expense - Station Equipment Wiring

By Order No. 81-625, Docket No. 81-168-C (September 1981), this Commission adopted the FCC's March 1981 amendments to certain provisions of the Uniform Systems of Accounts for Class A and Class B Telephone Utilities. The FCC's amendments require station equipment and wiring to be fully amortized by October 1991. Based upon its prior approval of the FCC's treatment of station equipment and wiring, the Commission finds it necessary to amortize the Company's remaining balance in Account 2321 within one year to meet the October 1991 deadline. Accordingly, the Commission adopts the Company's proposal to amortize the balance in Account 2321 in one year.

(M) Miscellaneous and Other Adjustments

The Commission adopts all other pro forma and accounting adjustments proposed by Staff and not objected to by any party. All other adjustments proposed by various parties not specifically addressed herein have been considered by the Commission and have been denied. The Commission has also adjusted all general, state, and federal taxes to reflect all other approved adjustments.

6. Based upon its acceptance of Staff's accounting and pro forma adjustments to the Company's operating expenses, the Commission concludes that the appropriate operating expenses for the Company's intrastate telephone operations for the test year under its present rates are $23,517,852.

7. Based upon its finding of an appropriate net operating income and operating expenses, the Commission concludes that the appropriate level of net operating income for return after accounting and pro forma adjustments is $4,835,078. This calculation is shown in Table A.

TABLE A
NET INCOME FOR RETURN

BEFORE RATE INCREASE	$
Operating Revenues	28,241,397
Operating Expenses	23,517,852
Net Operating Income	4,723,545
Interest During Construction	26,982
Customer Growth	84,551
Net Income for Return	4,835,078

8. Pursuant to S.C. Code Ann. §58-9-570 (1976), in ratemaking proceedings involving a telephone utility the Commission must "give due consideration to the telephone utility's property devoted to the public service...". This consideration is traditionally made in the context of the determination of the utility's rate base.

For ratemaking purposes, the rate base is the total net value of the telephone utility's tangible and intangible capital or property value on which the telephone utility is entitled to earn a fair and reasonable rate of return. Southern Bell Telephone & Telegraph v. Public Service Commission, supra. The rate base, as allocated to the Company's operations, is composed of the value of the Company's property used and useful in providing telephone service to the public, plus construction work in progress, materials and supplies, and an allowance for cash working capital and property held for future use; less accumulated depreciation, accumulated deferred income tax (liberalized depreciation) and customer deposits. Prior to the hearing, the Accounting Department of the Administration Division of the Commission Staff conducted an audit and examination of the Company's books and records, including rate base items, with plant additions and retirements. On the basis of this audit and the exhibits and the testimony contained in the entire record of the hearing, the Commission can determine and find proper balances for the components of the Company's rate base.

The Commission has considered each of the Company's proposed rate base items and concludes that the following components, with the noted adjustments, should be included in the Company's rate base:

(A) Items Associated with DirectoriesAmerica and the Estill Switch

The Commission has traditionally used the regulatory accounting methodology recognized as "original cost less depreciation" in the determination of the value of a telephone utility's plant in service. The record of this proceeding presents no justification for a departure from this methodology.

In light of the fact that the Commission has denied Staff's proposal to include 100% of the revenues of DirectoriesAmerica in the Company's operating revenues, the Commission likewise denies Staff's proposal to include the DirectoriesAmerica plant and the associated accumulated depreciation items in the Company's rate base. Correspondingly, the Commission denies Staff's proposal to include $151,583 in plant in service and $(56,417) in accumulated depreciation.

Further, the Commission concludes that the Estill switch should not be included in the Company's rate base for the purposes of this ratemaking proceeding because the switch was not in operation during the test year. The Commission declines to accept the Company's request to waive the Commission precedent of limiting rate base to investments in use during the test year. Accordingly, the Commission rejects the Company's proposal to include $615,296, and the associated accumulated depreciation of $(42,835), in its rate base.

(B) Wage Adjustments

The Commission concludes that the Company's wage increases which effect its plant should properly be included in the Company's rate base. Accordingly, the Commission accepts Staff's proposal to capitalize the Company's test year wage increases by $28,044.

(C) Contributions in Aid of Construction

The Commission accepts Staff's and the Consumer Advocate's proposal to eliminate customer advances in aid of construction. These customer contributions which are not investor-supplied should not be included in plant in service in the determination of the Company's rate base because the Company should not be permitted to earn a return on funds supplied by its customers.

(D) Materials and Supplies

The Commission has generally considered materials and supplies in inventory to be a proper item to be included in a telephone utility's rate base. The items normally contained in the materials and supplies component of the rate base include poles, cable, wire, repair parts and other equipment necessary for the provision of dependable telephone service. The Commission finds and concludes that the appropriate figure for materials and supplies to be included in the Company's rate base for its intrastate operations is $272,977. The Commission rejects the Consumer Advocate's proposal to allow the test year average of materials and supplies as the purpose violates the principle of reviewing a utility's books at the end of the year.

(E) Cash Working Capital

The Commission has normally considered an allowance for cash working capital to be an appropriate item for inclusion in the rate base of a telephone utility. By permitting a cash working capital allowance, the Commission acknowledges the requirement for capital expenditures related to the routine operations of the utility. In previous proceedings involving the Company, the Commission determined that the cash working capital allowance of twenty (20) days based on the Company's per book operating and maintenance expenses was appropriate. See, Order No. 85-200, Docket No. 84-390-C (1985). The Commission finds no reason to alter its computation of cash working capital. Accordingly, the Commission adopts Staff's proposal for cash working capital.

(F) Unclaimed Funds

The Commission finds that Staff's proposal to eliminate unclaimed funds from the Company's rate base is appropriate because the Company's investors should not be allowed to earn a return on funds to which they have not contributed. Therefore, the Commission accepts Staff's proposal to reduce the Company's rate base by $2,289.

(G) Customer Deposits

The amount representing customer deposits is considered an element upon which the Company's investors are not entitled to earn a return and is deducted from the Company's rate base. Consequently, the Commission finds that the Company's rate base should be reduced by $6,560 representing customer deposits. The Commission has treated the interest on customer deposits as a reduction to operating income in deriving the Company's overall rate of return.

(H) Accumulated Depreciation

The Company's investors are entitled to earn a return on those portions of the Company's plant which are used in its regulated business which have not been depreciated. Since the Commission has adopted Staff's proposals as to depreciation expense, the Commission concludes that the Company's rate base should properly be reduced by $51,116,731.

(I) Construction Work in Progress

This Commission has traditionally considered the reasonable and necessary costs of construction of utility plant not yet in service to be a proper rate base item. The Commission has uniformly allowed "construction work in progress" (CWIP) to be included in a telephone utility's rate base with an offset adjustment to operating income for return by that portion of the interest on funds used during construction attributable to the CWIP at the end of the test period.

In this proceeding, the Company and the Commission Staff proposed to include $1,148,326 as CWIP. Accordingly, the Commission will adopt that figure for ratemaking purposes herein.

The Company's rate base, as adjusted and determined by the Commission to be appropriate for the purposes of this proceeding, is set forth as follows:

TABLE B
ORIGINAL COST RATE BASE
September 30, 1990

	$
Gross Plant in Service	105,263,227
Accumulated Depreciation	(51,116,731)
Net Plant in Service	54,146,496
Telephone Plant Under Construction	1,148,326
Materials and Supplies	272,977
Cash Working Capital	795,547
Customer Deposits	(762,292)
Contributions in Aid of Construction	(300,210)
Accumulated Deferred Income Taxes	(6,508,420)
TOTAL RATE BASE	48,792,424

9. After establishing the appropriate rate base, it is the Commission's obligation to apply the Company's total operating income for return to the Company's rate base to determine what adjustments, if any, to the present rate structure are necessary to generate earnings sufficient to produce a fair rate of return to meet the needs of the utility. In Bluefield Water Works and Improvement Co. v. West Virginia Public Service Commission, 262 U.S. 679, 692, 43 S.Ct. 675 (1923), the Court stated the applicable constitutional standard as follows:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. . . .

This standard was reaffirmed by the Court in Federal Power Commission v. Hope Naural Gas Co., 320 U.S. 591, 64 S.Ct. 281 (1944), where the Court stated:

> ...the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital...

In the Permian Basin Area Rate Cases, 390 U.S. 474, 492, 88 S.Ct. 1344, 1373, 20 L.Ed.2d 312 (1968), the Court added that the results of a rate order must "fairly compensate investors for the risks they have assumed...." This Commission has acknowledged these standards and has applied them in numerous cases in the past.

It is clear from these cases that the capital structure selected by the Commission in this proceeding must be one which accurately reflects the business and financial risks presented by the utility which is the subject of regulation. Otherwise, the constitutional tests of reasonableness for a rate of return cannot be met. Moreover, the Commission is cognizant of its obligation pursuant to S.C. Code Ann., §58-9-570 (1976) to give "due consideration to...the capitalization of the telephone utility...."

The Commission finds that the applicable legal principles and the substantial evidence of record require that the consolidated capital structure of United Telephone System be adopted for use in this case. This finding is consistent with the recommendations of each of the cost of capital witnesses. The specific capital structure which the Commission adopts for use in this proceeding is depicted in the following table:

TABLE C
CAPITALIZATION - PER BOOKS

September 30, 1990

	Amount (thousands)	Ratio
Long-Term Debt	1,339,240	38.39%
Preferred Stock	15,552	.45
Common Equity	2,133,524	61.16
TOTAL	3,488,316	100.00%

The capitalization displayed in Table C reflects the actual consolidated capital structure of United Telephone System as of September 30, 1990, which the Commission finds fair and reasonable for ratemaking purposes in this proceeding. The capitalization and associated ratios have been utilized in the determination of a fair rate of return for the Company's operations.

10. In regard to the issue of cost of capital, the record indicates that, as of September 30, 1990, the embedded cost of long-term debt for the United Telephone System was 8.83%. The record also indicates that as of September 30, 1990, the embedded cost of preferred stock for the United Telephone System was 6.98%. Accordingly, the Commission concludes that the embedded cost of long-term debt of 8.83% and the embedded cost of preferred stock of 6.98% should be used in its determination of the cost of capital.

11. One of the principal issues in any ratemaking determination involves the proper earnings to be allowed on the

common equity investment of the regulated utility. In this proceeding, the Commission was offered the expert testimony of three witnesses relating to the fair and reasonable rate of return on common equity for the Company. These financial experts presented detailed explanations of a number of methodological approaches to the determination of the cost of equity capital.

The Commission's analysis of the evidence regarding the appropriate return on equity in this case must be guided by the constitutional principles set forth by the Supreme Court of the United States in Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, supra, and Federal Power Commission v. Hope Natural Gas Company, supra. These tests can be summarized as follows:

1. The allowed return on common equity should be the same as that earned on other investments of comparable risk.

2. Utilities have no constitutional right to profits realized by more speculative ventures.

3. The allowed return should be sufficient to maintain the utility's credit standing and enable it to raise necessary capital.

4. A reasonable return may vary over time reflecting changing economic conditions.

While the Commission adheres to no particular theory or methodology for the determination of a fair rate of return on common equity, it does test the various recommendations before it against these constitutional standards to determine the reasonableness of the approaches proposed by the various parties. With these legal standards in mind, the Commission is able to fulfill its function of engaging in a careful analysis of the abstract theories before it for application in a practical context.

The recommendations for return on common equity in this case range from a low of 12.50% to a high of 13.63%. In the final analysis, the Commission must appraise the opinions of the expert financial witnesses as to the expectations of investors and the opportunity costs of equity capital in conjunction with the tangible facts of the entire record of the proceeding, including the observable financial conditions of the Company.

In its determination of a fair and reasonable rate of return, the Commission maintains the ultimate responsibility of setting the rates to be charged for the telephone services provided by the Company in South Carolina. The exercise of that responsibility involves the balancing of the interests of the subscriber and of the investor. After full consideration of the opinions of the expert witnesses and after balancing the interests of the Company and the investor, the Commission finds that a fair and reasonable rate of return on common equity for the Company's operations in South Carolina is 12.75%, which is within the recommended ranges of both witness Legler and witness Spearman and is the best point estimate of witness Spearman.

12. The ratemaking process requires a determination of the overall rate of return which the utility should be allowed the opportunity to earn. This Commission has utilized the following definition of "rate of return" in previous decisions, and continues to do so in this proceeding:

> For regulatory purposes, the rate of return is the amount of money earned by a regulated company, over and above operating costs, expressed as a percentage of the rate base. In other words, the rate of return includes interest on long-term debt, dividends on preferred stock, the earnings on common stock and surplus. As Garfield and Lovejoy have put it 'the return is that money earned from operations which is available for distribution among the various classes of contributors of money capital. In the case of common stockholders, part of their share may be retained as surplus.'
>
> Phillips, The Economics of Regulation, pp. 260-261 (1969).

The amount of dollars permitted to be earned by the Company through the operation of its rate structure depends upon the jurisdictional rate base and the allowed rate of return on the rate base. Although the determination of the return on common equity provides the necessary component from which the rate of return on rate base can be derived, the overall rate of return, too, as set by this Commission, must be fair and reasonable.

The United States Supreme Court, in the decision of Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, supra, delineated general guidelines for determining the fair rate of return in utility regulation. In the Bluefield decision, the Court stated:

> What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all the same general part of the country on investments in other business undertakings which are attended by corresponding risk and uncertainties; but it has no constitutional rights to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper

> discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business generally.
>
> 262 U.S. pp. 692-693.

During the following years, the Supreme Court refined those precepts, and, in the landmark Hope decision, the Court restated its views:

> We held in Federal Power Commission v. Natural Pipeline Gas Co. . . .that the Commission was not bound to the use of any single formula or combination of formulae in determining its rates. Its ratemaking function, moreover involves the making of 'pragmatic adjustments' (cite omitted).... Under the statutory standard of 'just and reasonable' it is the result reached, not the method employed which is controlling (cites omitted). . . .
>
> The ratemaking process under the Act, i.e., the fixing of 'just and reasonable' rates involves a balancing of the investor and the consumer interests. Thus we stated in the Natural Gas Pipeline Co. case, that regulation does not insure that the business shall produce net revenues. (cite omitted) But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. (cite omitted). By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.
>
> 320 U.S. pp. 602-603.

The vitality of these decisions has not been eroded, as indicated by the language of the more recent decision of the Supreme Court in In Re: Permian Basin Area Rate Cases, supra.

This Commission has consistently operated within the guidelines set forth in the Hope decision.

The rate of return which the Commission has herein found to be fair and reasonable should enable the Company to maintain and enhance its position in the capital markets. Patently, however, the Company must insure that its operating and maintenance expenses remain at the lowest level consistent with reliable service and exercise appropriate managerial efficiency in all phases of its operations. The Commission has previously discussed the lack of existing reliable service in considering the cost of equity capital. The Commission has consistently manifested its abiding concern for the establishment and continuation of efficiency programs on the part of its jurisdictional entities. By its directive of August 27, 1974, the Commission urged the derivation of cost control studies, the adoption of cost reduction programs, and the elimination and reduction of costs "in all possible ways." In subsequent decisions, the Commission has restated its determination that effective programs of cost control will operate to promote the financial stability of its jurisdictional entities.

The Commission has found that the capitalization ratios for consolidated United Telephone System as of September 30, 1990, are appropriate and should be used for ratemaking purposes in the instant proceeding. Likewise, the Commission has found that the embedded cost rates for long-term debt and for preferred stock of 8.83% and 6.98%, respectively, should be utilized in the determination of a fair overall rate of return. For the purpose of this proceeding, the Commission has found the proper cost rate for the Company's common equity capital to be 12.75%.

Using these findings, the overall fair rate of return on the Company's South Carolina intrastate rate base may be derived as computed in the following table:

TABLE D

OVERALL RATE OF RETURN

	RATIO	EMBEDDED COST/RETURN	OVERALL COST/RATE
Long-Term Debt	38.39%	8.83%	3.39%
Preferred Stock	.45%	6.98%	.03%
Common Equity	61.16%	12.75%	7.80%
TOTAL	100.00%		11.22%

13. The Company's total income for return on its South Carolina intrastate operations after accounting and *pro forma* adjustments and after the approved increase is $5,474,510 which if divided by the original cost rate base of $48,792,424 as computed in Table B results in a return on rate base of 11.22% as of September 30, 1990. In order to achieve an overall rate of return on South Carolina intrastate operations of 11.22%, the Company would have required additional annual revenues of $1,021,768.

Total income for return, both before and after the approved increase in the Company's revenues, as found by the Commission, is illustrated in the following table:

TABLE E
TOTAL INCOME FOR RETURN

	Before Proposed Rate Increase $	After Proposed Rate Increase $
Net Operating Income for Return	4,723,545	5,362,977
Interest During Construction	26,982	26,982
Customer Growth	84,551	84,551
TOTAL INCOME FOR RETURN	4,835,078	5,474,510

The revenue requirements established herein are those found reasonable for the Company's South Carolina intrastate operations and which the Commission thereby finds appropriate for the test period, in recognition of the prospective application of the rates so approved. The Commission's approval of rates designed to meet the Company's revenue requirements is predicated upon a full review of the entire spectrum of issues presented in this proceeding, based upon the evidence in the record and upon the applicable legal parameters.

14. The revenue requirements of the Company having been determined, the Commission is also concerned with the identification of the specific rates and the development of the rate structure that will yield the required revenues. It is generally accepted that proper utility regulation requires the exercise of control over the rate structure to insure that equitable treatment is afforded each class of customer.

The three fundamental criteria of a sound rate structure have been characterized as follows:

> . . .(a) the revenue-requirement for financial-need objective, which takes the form of a fair-return standard with respect to private utility companies; (b) the fair-cost apportionment objective which invokes the prinicple that the burden of meeting total revenue requirements must be distributed <u>fairly</u> among the beneficiaries of the service, and (c) the optimum-use or consumer rationing objective, under which the rates are designed to discourage the wasteful use of public utility services while promoting all use that is economically justified in view of the relationships between costs incurred and benefits received.
>
> Bonbright, <u>Principles of Public Utility Rates</u> (1961), p. 292.

The record of this proceeding reveals considerable attention to the relative merits and application of the general notions of costing methodology and value of service in telephone rate design. The Commission has previously acknowledged the significance of those concepts in the derivation of a rate structure which fairly allocates revenue responsibility in a manner consistent with the less tangible notion of value of service.

The Commission recognizes both the inherent limitations and benefits of analyses based on cost as well as upon the value of telecommunications services. Furthermore, the record of this proceeding demonstrates that no single type of cost study can be made applicable to the wide range of services at issue before us. Nor do we determine in the context of this proceeding whether fully allocated cost studies would offer completely meaningful assistance in ratemaking. The record does not lead us inexorably to the conclusion that particular cost studies can be, or should be, the exclusive determinant for pricing telecommunications services. However, various costing methodologies have been applied to many of the rates and charges in the distribution of revenues proposed by the Company in this matter.

The Commission's analysis of the design and effect of the proposed rates and charges must begin and end with a recognition and reconciliation of the Commission's stated objectives to meet the reasonable revenue requirements fairly and to promote the economic equation of costs and benefits for the subscriber.

After fully reviewing the nature and extent of the Company's rate design proposals, and the proposals submitted by AT&T and Staff, and the concerns announced by the Consumer Advocate, the Commission approves the following rate design:

(A) Special Access Service

The Commission approves the Company's proposal to change its rates and charges for its Special Access Service to those which mirror its FCC approved interstate rate for similar interstate service. The Commission denies AT&T's proposal to require the Company to file an intraLATA private line tariff which reflects the same rates and structures as its intrastate Special Access tariff. Because AT&T concedes that the disparity between interLATA Special Access and intraLATA private line rates is not unique, the Commission concludes that it is not necessary for the Company to file an intraLATA private line tariff to address AT&T's concerns.

(B) Switched Access

The Commission approves the Company's proposal to restructure its Switched Access Service by aggregating end office switching, line termination, and intercept rate elements into one billable local switching element, establishing a single rate for all switch services provided in equal access offices, and providing a 55% discount for non-premium local switch services in non-equal access offices. While it is aware that there is no cost basis for any discount for non-premium switched services in non-equal access offices, the Commission recognizes that the majority of the Company's customers already enjoy the benefits of equal access and, therefore, the revenue impact of increasing the discount from 35% to 55% is minor. Moreover, the Commission recognizes that the Company will realize some benefit through ease of administration by having the same intrastate and interstate access rate structure.

(C) Improved Mobile Telephone Service

The Commission approves the Company's proposal to eliminate its Improved Mobile Telephone Service (IMTS) on May 30, 1991. The Commission finds that since the development of the cellular telephone market, the mobile telephone service has become technically outdated. Recognizing that cellular technology will be introduced in a portion of the Company's service area in February 1991, the Commission approves the discontinuance of the Company's IMTS.

(D) Directory Listing Services

The Commission approves the Company's proposal to increase the monthly rates for its directory listing services as follows:

PUBLISHED & NON-PUBLISHED LISTING

PRESENT	PROPOSED	INCREASE
$1.45	$1.75	$0.30

ADDITIONAL LINES IN DIRECTORY

	PRESENT	PROPOSED	INCREASE
1.	$1.15	$1.25	$0.10
2.	2.30	2.50	0.20
3.	3.45	3.75	0.30
4.	4.60	5.00	0.40

The Commission recognizes the value-added characteristics of the optional listings and that the additional annual revenue contributes to a lower residual revenue requirement for basic local ratepayers.

(E) Central Office Features

The Company has proposed a number of rate increases to its Central Office Features. These proposed changes are reflected below:

SERVICE DESCRIPTION	ACCOUNT	TYPE RATE	PRESENT RATE	PROPOSED INCREASE	INCREASE
1. Call Waiting		B	$2.00	$2.25	$0.25
		R	1.50	1.75	0.25
2. Three Way Calling		B	2.50	2.75	0.25
		R	2.00	2.25	0.25
3. Toll Block -					
Option 1		B	3.75	4.50	0.75
Option 2		B	3.75	4.25	0.50
Option 4		B	3.75	4.50	0.75
Option 5		B	3.75	4.50	0.75
Option 6		B	3.75	4.75	1.00
Option 7		B	3.75	4.00	0.25
Option 1		R	2.00	2.75	0.75
Option 2		R	2.00	2.50	0.50
Option 7		R	2.00	2.25	0.25
4. Direct-Inward-Dial Numbers -					
First 100		B&R	1.50	1.65	0.15
Next 300		B&R	1.25	1.40	0.15
Next 600		B&R	1.00	1.15	0.15
Over 1001		B&R	0.75	0.90	0.15
Rotary Hunt		B&R	13.00	16.00	3.00
Touch Tone		R	0.45	0.50	0.05

*B - Business
*R - Residence

The Commission approves the Company's changes to its Central Office Features. The Commission finds that the small increase in these optional features will contribute toward lower basic local rates.

(F) Advanced Business Connections Service

The Company has proposed several changes to its Advanced Business Connections Service (ABC). Specifically, the Company has proposed to increase the Network Access Register (NAR) rate to $50.00 to eliminate Touch Tone rates for ABC line rates, and to establish a $6.00 ABC line credit and a $6.00 NAR surcharge.

The Commission approves the Company's proposed changes to its ABC service. The Commission finds that because a subscriber to a Private Branch Exchange System (PBX) receives the same service, but for a smaller subscriber line charge than a subscriber to the Company's ABC service, the $6.00 ABC line credit should be approved. Moreover, the Commission approves the Company's proposal to bundle its charge for Touch Tone service into the rate element of its ABC service. The Commission finds that ABC customers will be charged for Touch Tone service and that Touch Tone service will not be subsidized.

(G) Zone Charges

The Company submitted a proposal to reduce its number of zones from four (4) to one (1). The Company proposes to charge a $2.00 monthly fee for residential and business customers located outside the base rate area. The Company also proposes a $1.75 monthly zone charge for multi-party customers.

The Commission finds that the reduction in zones is consistent with its intention of phasing out Zone Charges. Because of the increasing use of fiber optic facilities and remote switching systems into the telecommunication network, the reason for additional charges for lines located outside of the base rate area is decreased.

(H) Basic Local Exchange Charges

The Commission has found that the use of a residual pricing method best serves the public interest in South Carolina. Accordingly, the Commission first assigns additional revenues granted by the rate increase to optional and/or discretionary services. Thereafter, the remainder of revenues necessary to meet the revenues of the rate increase is assigned to basic services. Parker v. South Carolina Public Service Commission, 280 S.C. 310, 314 SE2d 148 (1984). The Commission recognizes, however, that it must strike a balance between the basic exchange and the practical recognition that there exists an elasticity of demand associated with the increase in supplemental services, particularily in the Company's competitive offerings.

In this proceeding, the Commission has approved additional revenues of $1,021,768. Of that amount, we have previously allocated $303,848 to General Subscriber and Access Services. It is necessary, therefore, to allocate the remaining revenues among the Company's basic local exchange services. These revenues representing the remainder of the granted increase shall be spread evenly among the Company's business and residential customers. The Company shall neither regroup exchanges nor provide a greater increase for two and four party customers.

IV.

CONCLUSIONS

Based upon the foregoing considerations and after a full review of the testimony and exhibits presented in this proceeding, the Commission has made the following findings and conclusions concerning the operations, the rate of return, and the reasonable requirements for earnings to be allowed the Company:

1. United Telephone Company of the Carolinas is a telephone utility providing telephone service in a service area within South Carolina and its operations in South Carolina are subject to the jurisdiction of this Commission, pursuant to S.C. Code Ann. §58-9-10, et. seq. (1976).

2. The appropriate test period for the purposes of this proceeding is the twelve month period ending September 30, 1990.

3. The Company is seeking an increase in its rates and charges to its South Carolina customers that will produce additional revenues, for the test period, of $1,664,357.

4. The year-end, original cost, South Carolina intrastate rate base of $48,792,424, consisting of the components set forth in Table B of this Order should be adopted.

5. The capital structure set forth in Table C of this Order should be approved.

6. Based on the capital structure used herein, the embedded cost of long-term debt, as of September 30, 1990, was 8.83%, and the embedded cost of preferred stock, as of September 30, 1990, was 6.98%.

7. A fair and proper cost of common equity for the Company is 12.75%.

8. The rate of return of 12.75% on common equity produced by the additional annual revenues of $1,021,768, as approved, is fair and reasonable.

9. The accounting and pro forma adjustments set forth in this Order are reasonable and proper and should be adopted.

10. The rate of return on rate base on the Company's South Carolina intrastate operations, during the test period, after accounting and pro forma adjustments, and prior to any rate adjustment was 9.91%.

11. The total income for return for South Carolina intrastate operations, after accounting and pro forma adjustments and prior to rate adjustments was $4,835,078 for the test period which is insufficient based on the reasonable rate of return found in this proceeding.

12. Approval should be given for rates which will provide additional gross revenues to the Company of $1,021,768, on its intrastate operations, which will produce a total income for return of $5,474,510.

13. The additional revenues allowed would produce a rate of return on approved rate base of 11.22% on South Carolina intrastate operations, which is found to be fair and reasonable.

14. The additional revenues and the return which these revenues produce are well within the range of reasonableness and fairness, and must be provided if the Company is to meet its

statutory requirements to provide reliable service.

15. The additional revenues would provide a rate of return on common equity allocated to South Carolina intrastate operations of 12.75%.

16. The schedules of Basic Exchange rates and charges as attached in Appendix A and approved by this Order, produce additional annual revenues of $717,920 and meet the statutory criteria of fairness and reasonableness, and should be approved for service rendered on and after May 28, 1991.

17. The Company should continue to file with this Commission, as previously ordered, quarterly reports showing:

(a) Rate of return on approved intrastate rate base;

(b) Return on common equity (allocated to intrastate operations);

(c) Earnings per share of common stock; and

(d) Debt coverage ratio of earnings to fixed charges.

ACCORDINGLY, IT IS THEREFORE ORDERED:

1. Company shall file with the Commission, for approval within sixty (60) days of the date of this Order, tariffs in accordance with the findings contained herein.

2. Company shall also file the quarterly reports identified above.

3. This Order remain in full force and effect until further Order of the Commission.

BY ORDER OF THE COMMISSION:

Marjorie Amos-Frazier

Chairman

ATTEST:

Executive Director

(SEAL)

UNITED TELEPHONE COMPANY OF THE CAROLINAS
APPROVED BASIC EXCHANGE RATES AND CHARGES

RATE GROUP 1

	APPROVED RATE
BUSINESS	
ONE-PARTY	$27.86
TWO-PARTY	$22.68
FOUR-PARTY	$18.10
TRUNK	$48.98
COCOT	$55.79
ONE-PARTY LMS	$16.73
TRUNK LMS	$29.37
COCOT LMS	$22.31
RESIDENCE	
ONE-PARTY	$13.00
TWO-PARTY	$11.38
FOUR-PARTY	$ 9.09
ONE-PARTY LMS	$ 6.50

RATE GROUP 2

BUSINESS	
ONE-PARTY	$31.68
TWO-PARTY	$25.77
FOUR-PARTY	$20.57
TRUNK	$55.59
COCOT	$63.37
ONE-PARTY LMS	$19.02
TRUNK LMS	$33.37
COCOT LMS	$25.34
RESIDENCE	
ONE-PARTY	$14.79
TWO-PARTY	$12.92
FOUR-PARTY	$10.32
ONE-PARTY LMS	$ 7.40